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SENSITIVE, SIPDIS

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TAGS: ECON EFIN CE
SUBJECT: Sri Lanka FY 2007 Budget

¶1. (SBU) Summary: President Mahinda Rajapakse, who is also the Finance Minister, presented the Government of Sri Lanka's (GSL's) FY 07 budget to Parliament on November 16. The budget envisages large increases in both expenditure and revenue. Military expenditure will increase by 28 percent to a record Rs 139 billion (USD 1.3 billion or 4.2 percent of GDP) in 2007. Due to past fiscal largesse, two-thirds of government expenditure still goes to cover recurrent expenditures. Despite a whopping USD 1 billion projected increase in revenue estimates, there were no significant tax hikes, although some sectors will see their tax liability increased. The largest benefit to the private sector will come from reduced electricity prices. The budget also granted specific assistance to a few selected industries and agriculture. The GSL hopes to post a small recurrent account surplus, although the government is highly unlikely to meet that target. The budget includes substantial infrastructure spending. It was presented within the context of a three year framework, enabling the President to speak of plans without actually budgeting for them. Despite criticism that the budget failed to lower cost of living, all political parties in Parliament except for one voted in favor of the budget in a rare show of unity. End Summary.

¶2. (SBU) President Mahinda Rajapakse, who is also the Finance Minister, presented Sri Lanka's FY 07 budget, his second, to Parliament on November 16. Unlike his first, made shortly after being elected, the 2007 budget did not offer significant increases in subsidies and handouts and contained some initial efforts to reform expenditure. Opening the budget speech, Rajapakse said he was presenting the budget based on "Mahinda Chintana" (or "Mahinda's Thoughts"), an election document filled with subsidies and envisioning development of the rural poorer regions of the country. (Comment: Mahinda Chintana is cited to justify most GSL actions, especially those involving economic development. End Comment.) However, the budget was remarkably short on Mahinda Chintana-like policies that would have stretched the budget even further. Mahinda appealed to the LTTE to enter peace talks and lay down arms, while listing difficulties faced due to increased violence. He used the increased violence to highlight the GSL's focus on security and his inability to bring down the cost of living, stressing that people need to make sacrifices.

¶3. (SBU) FISCAL DATA, 2006-2007: The following statistics provide a comparison between the projected (original) budget for 2006, the revised 2006 budget and the 2007 projected budget. The figures in parentheses represent the percentage of GDP.

Year	2006 Proj.	2006 Rev.	2007 Proj.

In billions of rupees

Total Expenditure	732 (27)	722 (26)	898 (28)
-current	509 (19)	547 (20)	596 (18)
-capital	226 (8)	184 (7)	303 (9)
---Of which are fully funded projs.	21(1)	21 (1)	63 (2)
Total Revenue	484 (18)	482 (17)	600 (19)
Budget Deficit(a)	225(8.3)	218 (7.9)	235 (7.2)
Budget Deficit(b)	247(9.1)	239 (8.6)	297 (9.2)
Financing (net)			
Foreign	124	84	142
Domestic	123	156	156

Notes:

Exchange rate: USD1 = approximately Rs 104 in 2006 and Rs 110 in ¶2007.
Figures within parenthesis represent percentage of GDP.

(a) Sri Lanka's Official Budget Deficit reported by the Finance Ministry: There are two deficit numbers. The Finance Ministry understates the budget deficit by excluding foreign funded tsunami and development projects implemented through the government in expenditure. Accounting for these foreign funded projects in government expenditure will result in a higher deficit.
(b) Embassy-Estimated Actual Budget Deficit: We have included foreign-funded projects in expenditure, and therefore have used the higher deficit in our analysis.

BUDGET PROJECTIONS

¶4. (SBU) The budget has been structured with the expectation that both government spending and revenue are estimated to grow significantly, by 24 percent, resulting in a deficit of about 9.2 percent of GDP in 2007. The government is set to borrow about Rs 230 billion (USD 2.1 billion) in 2007, over and above the Rs 63 billion (USD 570 million) project lending that has already been secured in order to bridge the budget deficit. In 2006, despite substantial overruns in recurrent expenditure, the fiscal deficit was held at 8.6 percent of GDP through cuts in capital spending. The government has not been able to meet targets set by the Fiscal Management Responsibility Act (FMRA) which sets a deficit target of 5 percent for 2006 and beyond.

¶5. (SBU) The 2007 budget foresees a large increase in capital expenditure compared to 2006. However, almost two-thirds of government expenditure (equivalent to about 18 percent of GDP) has been allocated for recurrent expenditure. Although committed expenditure on wages, interest and subsidies leaves little room for allocating funds to vital sectors, the budget makes some effort to rationalize expenditure. As an example, the government plans to spend less on subsidies and more on education and health in 2007. However, defense expenditure is set to increase substantially in 2007 (see para 9).

¶6. (SBU) Revenue estimates seem precariously optimistic. Total revenue is estimated to increase by 24 percent (Rs 112 billion or USD 1 billion) to over 18 percent of GDP. The increase is not in line with inflation and growth. In 2006, revenue increased by 29 percent following substantial increases in taxation. Therefore, in the absence of a similar tax hike, it is unlikely the government will meet this target in 2007. The fiscal direction of the budget, however, was laudable as the government has budgeted for a marginal surplus in the current account (revenue-current expenditure), which indicates that revenue would be sufficient to cover current expenditure.

MACROECONOMIC MANAGEMENT

¶7. (SBU) According to the President, the government is designing a 10 year strategy which aims at an annual GDP growth of over 8 percent and raises the per capita income from the current USD 1,200 to USD 3,000. In 2007, economic growth is expected at 7.5 percent, up from 7 percent in 2006. Inflation and monetary expansion were high in 2006 due to high oil prices and increased borrowing by both government and private sector. Dr P B Jayasundera, Treasury Secretary, speaking at a post-budget seminar said he expects

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inflation to moderate to around 9 percent in 2007 with measures taken to tighten monetary policy. However, revealing the government stance on inflation, he said the government would not sacrifice economic growth for lower inflation.

INFRASTRUCTURE FOCUS, IN PART

¶8. (SBU) The government expects capital spending to increase dramatically from Rs 184 billion (USD 1.7 billion) in 2006 to Rs 303 billion (USD 2.8 billion) in 2007. While this increase is touted as investment in further economic development, it should be noted that all of this will not be for key economic infrastructure. Some of the funding will be for defense, office buildings and vehicles. Key infrastructure projects which are already funded and included in the budget are the Norochcholai coal power plant (funded by China), the Southern expressway (ADB/Japan), the Colombo south harbor breakwater (ADB), the outer Colombo circular road (Japan), and the Kotmale hydro power project (Japan). There are other key projects, which still need to be funded. This latter investment, however, will depend on foreign inflows and domestic investors. There are concerns that with the increased violence and the breakdown of the peace process it will be difficult to attract foreign investors in the scale envisaged by the government. The IMF has also warned the country against borrowing on commercial terms. The budget proposed a new tax of 2.5 percent on motor vehicle imports to fund infrastructure.

INCREASE IN DEFENSE SPENDING

¶9. (SBU) Defense spending will increase by 28 percent to a record Rs 139 billion (USD 1.3 billion) in 2007 (4.2 percent of GDP), and could increase further if the conflict escalates. Defense spending was Rs 108 billion (3.9 percent of GDP) in 2006 and Rs 83 billion

(3.5 percent of GDP) in 2005. Various groups have criticized higher defense spending, leading to the impression that the government is preparing for a war. But a large portion of the increase is due to inflation, currently at 18 percent. Further, in these more tense times, the government will increase the GDP percentage for defense by 0.7 percent compared to 2005. In support of the increased defense spending, Jayasundera said that national security "cannot be compromised." Further, not only the war, but the need to maintain law and order and reduce crime compelled the government to increase defense spending. In addition, salary increases (due to increases granted to public service including military) also contributed to the rise in expenditure.

CONTROVERSIAL PROPOSALS LEADING TO A MORE BLOATED GOVERNMENT

¶10. (SBU) In keeping with Mahinda Chintana, big government was seen prominently in the budget. For instance, the government proposed to control dividend distribution of private companies. Accordingly, companies that pay less than 25 percent of their distributable profits as dividends are required to pay a penalty tax of 15 percent, on top of normal tax on profits. This proposal has been widely discussed. Companies say they need to save to fund future investment. Capital market analysts argue that boards of directors should be allowed to decide how much they would distribute and how much they would keep for future needs. In addition, the government made it mandatory for insurance companies to cede 50 percent of the re-insurance business with the new state-owned National Insurance Trust Fund, which has raised concerns regarding quality of insurance products in the future. The government also proposed to create a National Wealth Corporation to own and manage government lands and other assets. A new bank named Lanka Putra Bank, will take over

functions of regional development banks (RDB) and the newly created SME Bank. There are concerns that the new bank will centralize functions of the regional development banks, leading to inefficiency and corruption. Already, Fitch Ratings has put the regional development banks on its rating watch. In another move, the budget declared that Sri Lankans working overseas should get a minimum wage of USD 250 per month from 2007. The government argues this move will ensure that Sri Lanka will provide a pool of skilled labor for overseas market. Currently, the majority of Sri Lankans working overseas are female housemaids. Foreign remittances of over USD 2 billion are the second largest source of foreign exchange to Sri Lanka after garment exports. Although not mentioned in the budget, the disruption of families due to migration of women has become a social issue.

A PASSING MENTION OF MUCH NEEDED REFORMS

¶11. (SBU) The budget speech briefly mentioned the need for crucial reforms. Among them was a government commitment to monthly adjustments to petroleum prices in line with world prices. On labor and education, the President said that educated youth are not capable of securing gainful employment and stressed the need to re-orient education and improve the studies programs in universities and vocational institutes. There was no mention of new programs to address this issue to expand English education, nor the status of the current efforts. The budget speech also mentioned the need for judicial reforms, and the need for management and unions to work together to strengthen performance in key public services such as electricity, ports and petroleum.

¶12. (SBU) The budget was silent on much needed welfare reforms, public sector reforms and public enterprise reforms. However, on the positive front, total expenditure on subsidies and welfare programs have been reduced from 4.9 percent of GDP in 2006 to 3.9 percent of GDP. The allocation for Samurdhi, the main income transfer (welfare) program has declined from 0.7 percent of GDP in 2006 to 0.5 percent of GDP in 2007. According to a recent report by the Colombo-based Institute of Policy Studies (IPS), efforts to improve targeting are underway. As a first step, over 40,000 recipients have voluntarily exited the program by mid 2006. Currently, there are over 1.9 million Samurdhi recipients.

ENORMOUS CIVIL SERVICE A DRAIN ON THE BUDGET

¶13. (SBU) The public sector wage and pension spending of Rs 265 billion in 2007 has become a drag on the budget. These expenses will use 45 percent of government revenue. The public sector is to be given a part of a salary increase announced in the 2006 budget. In addition, the government has proposed to add another 8,000 graduates to the approximately 1 million-strong public sector workforce in keeping with a 2006 budget proposal. The government

has absorbed 45,000 graduates in 2005-2006, fulfilling the prior administration's promises, and partially fulfilling the President's election promise. On the positive side, the budget proposes to rationalize the salary structure and improve the recruitment policy.

TAXATION

¶14. (SBU) Both direct and indirect taxation have risen sharply in recent years. Private companies in various sectors have complained of the high tax obligations and reporting complexities in Sri Lanka. According to the World Bank's Doing Business 2007 report, Sri Lanka ranked 157 out of 175 countries in terms of tax liability/ease of paying taxes. However, in the absence of significant government efforts to control recurrent spending, taxation is expected to continue expanding.

¶15. (SBU) The FY 2007 budget heaps additional taxes on businesses while curtailing leakages from the system.

Some of the increases are:

--a 0.5 percent increase in the ports and airports levy to 3

percent
--limiting input tax credit under the VAT and extending its coverage
--lowering income threshold for economic service charge
--changes to tax treatment of loan loss provisioning in banks
--insurance companies will not be able to offset losses from life policies against profits in general business
--increase in imputed profit margins for the calculation of VAT and Export Development Board levy.
--Export Development Board levy on selected items was increased.

INDUSTRY ASSISTANCE

¶16. (SBU) Noting that industries were fast losing their competitiveness due to the high prices of electricity and industrial fuel (used to generate electricity in some plants), the budget proposed to lower the electricity tariff. This will be done by exempting electricity from VAT. In addition, agriculture, livestock, prawn farming and construction will benefit from industry-specific assistance which ranged from VAT exemptions and concessionary duty for imported machinery to a Rs 3 billion credit line for farmers. The following industries benefited from protection through increases in import tariffs and other import charges, as well as VAT exemption on local manufacture: handloom textiles, bus transport, panels, footwear, jewelry, and personal care products. The local film industry was also given various generous concessions.

MIXED REACTIONS

¶17. (SBU) The budget received mixed reactions. Sectors projected to obtain government assistance have been quick to praise the budget. For example, the Gem and Jewelry Association termed the budget "a glittering budget" as a result of concessions granted to the industry. Overall, the private sector chambers have praised the infrastructure program of the budget while asserting the need for the implementation of the proposals. They have also praised the VAT exemption on electricity as it will enhance the competitiveness of industries. The dividend tax, however, received heavy criticism. Trade unions representing the private sector have condemned the budget as it did not grant them any concessions.

¶18. (SBU) Following the joint government-United National Party (UNP) Memorandum of Understanding to work together on the security situation in the country, the UNP has agreed to support the budget in principle. Nevertheless, during parliamentary discussions of the budget, the UNP blamed the government for not addressing the rising cost of living and for pushing the country into war. The UNP urged the government to pursue the peace process. The Janatha Vimukthi Peramuna (JVP) and the Jathika Hela Urumaya (JHU) have complained that the budget did not contain their proposals and that it is not a people friendly budget. Tamil National Alliance (TNA) members allege that defense expenditure is increasing to buy warplanes and ships in preparation for war.

¶19. (SBU) The budget was passed by an overwhelming majority of 130 votes, with 142 voting for and 12 against. The UNP, JVP, JHU, CWC and SLMC voted with the government, with only the TNA opposing. This was the first time in recent history that a budget received

such broad support amongst the political parties.

¶20. (SBU) Comment: The government's FY 07 fiscal targets, for both revenue and expenditure, seem overly ambitious and unrealistic. In particular, revenue is expected to increase by 24 percent (Rs 112 billion or USD 1 billion). As such, as seen in recent years, a fall in revenue and recurrent expenditure overruns are likely to be met by cuts in capital spending. Government borrowing in 2007 is likely to rise further than anticipated and contribute to further depreciation of the rupee and fuel inflation which could stifle growth. However, the budget was able to underline some economic realities. The government should be commended for not granting new subsidies, and for attempting to end the oil subsidy despite the rising cost of living. Further, while the budget did not contain a clear path for economic development, it signaled the government's

stand on infrastructure. Stronger fiscal adjustments and reforms will be needed to attain macro economic stability which will create room for private sector development and economic growth in the 8 percent range in the medium term.
BLAKE